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C O N F I D E N T I A L BRASILIA 8391

E.O. 11652: GDS

TAGS: PFOR; PR; US; BR

SUBJ: FIRST MEETING OF HIGH LEVEL CONSULTATIVE MECHANISM -
BRAZIL'S ECONOMIC SITUATION

1. INHERITING SEVEN YEARS OF RAPID BUT UNEVEN ECONOMIC GROWTH, PRESIDENT GEISEL NOW CONFRONTS WHAT MAY BE ONE OF THE MOST SERIOUS ECONOMIC CHALLENGES FACED BY ANY BRAZILIAN PRESIDENT SINCE THE MIDDLE SIXTIES. HIS GOVERNMENT'S ABILITY TO DEAL WITH THESE DIFFICULTIES OF BRAZIL'S DOLS 100 BILLION ECONOMY WILL HAVE IMPORTANT CONSEQUENCES FOR BRAZIL'S ECONOMIC AND, INDEED, POLITICAL DEVELOPMENT.

2. BRAZIL HAS PRIDED ITSELF ON MAINTAINING SUBSTANTIAL ECONOMIC GROWTH THROUGHOUT THE RECENT GLOBAL RECESSION-- DESPITE ITS HEAVY DEPENDENCE ON IMPORTED OIL (80 PERCENT) AND THE REAPPEARANCE, SINCE 1974, OF A SUBSTANTIAL TRADE DEFICIT. THE GEISEL ADMINISTRATION HAS MAINTAINED AND INCREASED PUBLIC AND PRIVATE INVESTMENT ACTIVITY, WHILE ALSO SEEKING TO SOFTEN THE HIGHLY UNEVEN INCOME DISTRIBUTION THROUGH A MORE LIBERAL WAGES POLICY. WITH IMPORTS SEVERELY CONSTRAINED THROUGH ADMINISTRATIVE AND
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FISCAL CONTROLS -- IMPORTS, IN REAL TERMS, HAVE BEEN DECLIN-

ING SINCE 1974 -- THE ECONOMY HAS SHOWN SIGNS OF SEVERE OVERHEATING THIS YEAR, ALTHOUGH EXPANSION NOW APPEARS TO BE LEVELING OFF. OUTPUT OF GOODS AND SERVICES ROSE BY 8-9 PERCENT DURING THE FIRST SIX MONTHS THIS YEAR -- BUT PRICES ROSE EVEN MORE RAPIDLY, BY 30 PERCENT. FOR THE YEAR AS A WHOLE, INFLATION IS EXPECTED TO EXCEED THE 50 PERCENT MARK. THE CURRENT ACCOUNT IS AGAIN EXPECTED TO REGISTER A DEFICIT OF OVER DOLS 6 BILLION. TOTAL FOREIGN DEBT (PUBLIC AND PRIVATE) IS EXPECTED TO REACH DOLS 27 BILLION (UP BY MORE THAN DOLS 5 BILLION).

3. BRAZIL'S ECONOMIC DIFFICULTIES ARE ACCENTUATED BY POLITICAL AND ECONOMIC FACTORS:

--THE MORE LIBERAL WAGES POLICY HAS BEEN POPULAR -- ALTHOUGH IT PRODUCED A BEST LIMITED POLITICAL BENEFITS FOR THE GOVERNMENT AND NOW SEEMS TO HAVE BEEN HALTED, VICTIM OF THE ANTI-INFLATION CAMPAIGN. PRESIDENT GEISEL'S GREAT PERSONAL POPULARITY DERIVES PARTLY FROM IT. CONVERSELY, ECONOMIC AUSTERITY WILL BE ADDING TO POLITICAL TENSIONS, WITH POSSIBLE FURTHER ADVERSE CONSEQUENCES FOR THE GOVERNMENT PARTY'S ALREADY POOR STANDING WITH THE ELECTORATE. --STRETCH-OUT OF INVESTMENTS PROJECTS IN HIGH PRIORITY BASIC INDUSTRIES WILL DELAY THE COMPLETION OF IMPORTANT IMPORT SUBSTITUTION AND EXPORT PROGRAMS. BRAZILIAN STRATEGY ULTIMATELY DEPENDS GREATLY ON THESE INVESTMENTS FOR OVERCOMING THE EXTERNAL PAYMENTS CONSTRAINTS TO RAPID ECONOMIC GROWTH.

--TIGHTER MONETARY POLICIES -- WHICH HAVE BEEN SLOW TO COME -- FALL HEAVILY ON THE BRAZILIAN PRIVATE SECTOR WHICH, UNLIKE THE SUBSIDIARIES OF MULTINATIONALS AND THE GIANT STATE-OWNED PUBLIC COMPANIES, HAS ONLY LIMITED ACCESS TO FOREIGN CAPITAL MARKETS. AGRICULTURAL INTERESTS IN THE POLITICALLY IMPORTANT SOUTH, INDUSTRIALISTS FROM THE KEY STATES, AND BRAZILIAN IMPORTERS ALL ARE RESISTING TIGHTER POLICIES.

--AS A RESULT OF THESE FACTORS, THERE HAS BEEN CONSIDERABLE HESITATION, UNCERTAINTY, LACK OF COORDINATION, AND EVEN MIS-CALCULATION ON THE PART OF POLICY MAKERS IN APPLYING THE CONFIDENTIAL

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NEEDED MEASURES. ROSY OFFICIAL PREDICTIONS HAVE HURT THE ADMINISTRATION'S CREDIBILITY. AS THE CURRENT HIGH RATE OF INFLATION DEMONSTRATES, THE REVERSAL OF EARLIER TIGHT CREDIT POLICIES IN MID-75-- MOTIVATED BY FEAR OF RECESSION --WAS PREMATURE. THE EXPANSIONARY CREDIT POLICIES IN THE SECOND HALF LAST YEAR CLEARLY OVERSHOT THE MARK, UNDERESTIMATING THE INCREASE IN PUBLIC SECTOR SPENDING AND THE BASIC DYNAMISM OF THE BRAZILIAN ECONOMY.

4. THE EXTERNAL IMBALANCE WILL PROVE JUST AS HARD TO SOLVE AND OPEC'S PROSPECTIVE PRICE INCREASES WILL COMPLICATE THE EFFORT. WITH AN OIL IMPORT BILL OF DOLS 4 BILLION, SOME 40 PERCENT OF BRAZIL'S EXPORT EARNINGS NOW GO TO PAY FOR PETROLEUM IMPORTS. DEVALUATIONS SINCE 1974 HAVE KEPT IN STEP WITH THE DIFFERENTIAL RATE OF INFLATION BUT HAVE NOT COMPENSATED FOR THE 20 PERCENT DEADLINE IN THE TERMS OF TRADE. IN THE SHORT TERM, HIGHER EXPORT GROWTH MAY BE DIFFICULT TO ACHIEVE, EVEN WITH MORE RAPID DEVALUATION. OVER THE LONGER TERM, SIGNIFICANT IMPROVEMENT WOULD RESULT FROM SUCH A MOVE.

5. NOTWITHSTANDING THESE MANY UNCERTAINTIES -- AND THE RELATIVELY HIGH DEBT SERVICE RATIO (40 PERCENT) -- INTERNATIONAL INVESTOR CONFIDENCE HAS REMAINED STRONG. TO COVER ITS FINANCING REQUIREMENTS -- CLOSE TO DOLS 9 BILLION ANNUALLY (CURRENT ACCOUNT DEFICIT PLUS REPAYMENT OF LONG-TERM DEBT -- BRAZIL HAS RESORTED TO MASSIVE EXTERNAL BORROWING -- ON THE ORDER OF DOLS 7.5 BILLION GROSS, ANNUALLY, SINCE 1974. WE WOULD EXPECT THAT BRAZIL WILL CONTINUE TO OBTAIN THE REQUIRED EXTERNAL FINANCING PROVIDED THE GEISEL ADMINISTRATION DEMONSTRATES REASONABLE PROGRESS IN COMBATING INFLATION, FASTER EXPORT GROWTH, AND FURTHER GRADUAL REDUCTION IN THE TRADE DEFICIT. HOWEVER, WHILE CONTINUING TO DEMONSTRATE CONFIDENCE, THE INTERNATIONAL FINANCIAL COMMUNITY WILL HENCEFORTH MONITOR BRAZIL'S ECONOMIC POLICY FAR MORE CLOSELY, WITH A MORE CRITICAL AND WARY EYE, THAN EVER BEFORE. ANY MAJOR MISSTEPS, WHETHER THE RESULT OF MISCALCULATION OR OVERCONFIDENCE, COULD HAVE VERY SERIOUS CONSEQUENCES.

6. WE BELIEVE THERE IS A GOOD-TO-REASONABLE CHANCE THAT
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THE GEISEL ADMINISTRATION WILL BE ABLE TO BRING THE PROBLEM UNDER CONTROL. THE KEY INGREDIENT WILL BE THE POLITICAL WILL TO PURSUE UNPOPULAR MEASURES. THE PATTERN OF HIGHLY INFLATIONARY EXPECTATIONS WILL NOT BE EASY TO REVERSE, AND WILL REQUIRE STRONG AND PAINFUL, STEADILY APPLIED MEASURES FOR A CONSIDERABLE PERIOD OF TIME (IE., 12 - 18 MONTHS) -- REDUCTION OF GROWTH TO PERHAPS 4 PERCENT OR LESS, STRETCH OUT OF KEY INVESTMENT PROJECTS, AND MOVEMENT TOWARD A MORE REALISTIC EXCHANGE RATE (INCREASING THE CRUZEIRO VALUE OF FOREIGN DEBT). MORE FUNDAMENTALLY, THE PRESENT DIFFICULTIES RAISE QUESTIONS ABOUT THE ADEQUACY OF THE GOVERNMENT'S GRADUALIST APPROACH (I.E., THE CRAWLING PEG SYSTEM AND GENERALIZED INDEXATION TO NEUTRALIZE INFLATION). EVEN MORE COMPLEX WILL BE MANAGEMENT OF THE POLITICAL REPERCUSSIONS OF A SUSTAINED PERIOD OF AUSTERITY AS THE REVOLUTION --,

ITS LEGITIMACY BROUGHT INTO DOUBT BY ECONOMIC DIFFICULTIES
--LOOKS BEYOND THIS YEAR'S MUNICIPAL TO THE 1978 CONGRES-
SIONAL AND GUBERNATORIAL ELECTIONS.
JOHNSON

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